



Mike Monahan
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November 4, 2016

Ms. Susan M. Cospers
Technical Director
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856-5116

Re: Derivatives and Hedging Proposed Accounting Standards Update, File Reference No. 2016-310

Dear Ms. Cospers:

The American Council of Life Insurers¹ (“ACLI” or “we”) appreciates the opportunity to comment on the FASB Derivatives and Hedging Proposed Accounting Standards Update (“proposed ASU” or “exposure draft”). We are very supportive of the stated FASB objective of “improving the financial reporting of hedging relationships to better portray the economic results of an entity’s risk management activities”. The ACLI is in favor of many of the proposed changes in the exposure draft, but believe some of these proposals could potentially have more positive impact on the above FASB objective with some adjustment (see section I). Also, the aforementioned FASB objective could be significantly further advanced by adoption of changes in reporting that are not currently in the exposure draft (section II).

I. Comments On Proposals Included In The Exposure Draft

Risk Component Hedging

We support the addition of the SIFMA Municipal Swap Rate as an eligible benchmark interest rate, as well as the exposure draft’s contractually specified interest rates for hedge accounting qualification. However, greater realization of the aforementioned FASB objective would likely occur if more market rates were eligible for hedge accounting. This assumes they are part of an arm’s length derivative trade with a third party, are reliably measurable (e.g., prime rate, which appears to meet the definition of benchmark interest rate in that it can be attributable to high-credit-quality obligors), and do not have significant credit risk embedded in them. Overall, the ACLI favors a more principle based approach that would emphasize current existing effectiveness test thresholds as the main decider of hedge accounting qualification (i.e., passing the highly effective test can serve as the backbone to hedge accounting eligibility).

¹ The American Council of Life Insurers (ACLI) is a Washington, D.C.-based trade association with approximately 280 member companies operating in the United States and abroad. ACLI advocates in state, federal, and international forums for public policy that supports the industry marketplace and the 75 million American families that rely on life insurers’ products for financial and retirement security. ACLI members offer life insurance, annuities, retirement plans, long-term care and disability income insurance, and reinsurance, representing 95 percent of industry assets, 92 percent of life insurance premiums, and 97 percent of annuity considerations in the United States. Learn more at www.acli.com.

Refining the Accounting for the Hedged Item in Fair Value Hedges of Interest Rate Risk

We are supportive of the proposed partial term fair value hedges, prepayable financial instruments' fair value change calculation (permitting consideration of only benchmark interest changes on prepayment probability), and the benchmark rate component fair value change proposals (permitting the fair value change be based on the benchmark rate component vs. full contractual cash flows). More significantly (and similar to the principle based approach noted above), we believe all components that are separately identifiable and reliably measurable should be permitted as hedged items in hedge accounting relationships, as long as current GAAP effectiveness tests are met. This would provide greater realization of the overall FASB objective of "improving the financial reporting of hedging relationships to better portray the economic results of an entity's risk management activities".

Recognition and Presentation of the Effects of Hedging Instruments

While we agree with reporting the effect of the hedging instrument in the same income statement line as the hedged item, we do support the following clarifications:

- Net interest margin (net investment income less product crediting rates) and other related measures are key indicators of insurance company operating performance. Because net investment income (NII) and interest expense drive many of these significant financial metrics, we support a bifurcation approach that: 1) records the interest portion of derivatives and hedged items in the same income statement line (e.g., NII, interest expense), and 2) records other related hedge and hedged item components (including ineffectiveness) in another gain/loss line in the income statement (e.g., realized gain/loss).

We are concerned that recognizing ineffectiveness with the hedged item in the same financial statement line could have some unintended consequences and be misleading to investors, depending on the size of an insurer's hedging program. For example, if a hedged forecasted debt issuance does not occur, the proposed guidance seems to indicate that the (now de-designated cash flow hedge accounting derivative) impact be reclassified from OCI to interest expense. Since the hedged item did not materialize in the financial statements, we believe the hedge would be more reasonably recorded with other derivatives where non-hedge accounting is applied.

We are also concerned about the deferral of amounts in OCI from cash flow hedge ineffectiveness. One could support the premise that the ineffective part of a hedging derivative is hedging "nothing" (i.e., speculative), and therefore should be recognized in earnings immediately. This is not an issue for fair value hedges, since their entire fair value changes are recognized in earnings. Deferring large (ineffective) amounts in OCI can cause earnings surprises to investors when accumulated amounts are reclassified to earnings.

Other Simplifications of Hedge Accounting Guidance

- We are supportive of the proposal for more flexibility (e.g., until quarter-end) to perform initial quantitative assessment of hedge effectiveness. However, some companies may not utilize this option, as contemporaneous testing can avoid possible quarter-end surprises that could come with delaying the tests.
- The ACLI also supports the proposed qualitative testing option, which could potentially save significant operational resources. However, (similar to above) some companies may not utilize this option due to the qualitative compliance documentation (and accompanying audit inquiries), and the fact that quarterly quantitative testing (for non-critical terms and shortcut items) avoids accumulated year-end surprises for companies and investors.

- We also support the critical terms 31-day time period allowance and believe this will likely have significant impact by lowering operational time (without adding risk of ineffective relationships receiving hedge accounting).
- Also, permission of long-haul method when short-cut method is no longer appropriate is a very valuable and important change that we support. This removal of accounting risk will likely motivate more use of the short-cut method and hedge accounting overall. Use of long-haul (when short-cut is no longer appropriate) instead of no hedge accounting will better reflect the hedge economics in the financials over the entire hedge life.

Disclosures

Because current derivative footnote disclosures (along with derivative information included in the fair value footnote) are significant, we believe the information associated with the additional proposed disclosures are already adequately covered by current disclosures quantitatively and/or qualitatively. Also, while hedging strategies are described qualitatively in detail in current disclosures, some companies do not set quantitative hedge accounting goals. Our industry seeks to hedge risks through the use of the most appropriate hedging methods (including derivatives) and apply hedge accounting when permissible under FASB guidance.

Effective Date

We believe the effective date should be no sooner than 2 years from release of the final guidance and that early adoption should be permitted.

II. Proposals Not Included In The Exposure Draft

Portfolio Hedge Accounting

Insurance companies economically hedge various capital market risks inherent in their asset and liability portfolios. Although these are effective hedges of the underlying market risks on an economic basis, they bring about significant earnings distortion in the U.S. GAAP income statement due to the lack of the ability for these portfolio hedges to qualify for hedge accounting treatment under ASC-815. Under current U.S. GAAP, qualifying for hedge accounting on a portfolio basis requires a level of homogeneity among the hedged items. A group of similar assets, liabilities, or forecasted transactions may be designated as the hedged item in a fair value or cash flow hedge; however, "similar" is interpreted narrowly, e.g.,

- Hedging interest payments on several variable-rate debt instruments
- Hedging FX on a portfolio of bonds
- Hedging first \$1M of purchases in 201X

The FASB Hedge Accounting Project deliberations noted lack of widespread use of shortcut method due to restrictions. The Board effectively mitigated these restrictions in the exposure draft (e.g., restatement with long-haul, etc.), which will likely increase use of this election. Similarly, portfolio hedge accounting often is not utilized for portfolio hedges due to current hedge accounting restrictions. This generates misleading financial statements; as the hedges are marked-to-market through earnings, and the hedged items typically are not marked-to-market in earnings. Accordingly, we suggest eliminating homogeneity hedged item requirement if effectiveness passes existing guidance criteria (i.e., via regression of multiple scenarios, as qualitative testing would not be appropriate). This eliminates financial statement distortions from effective portfolio hedges.

The above represents a theory shift towards effectiveness testing as the primary criteria for hedge accounting and would increase use of portfolio hedge accounting (e.g., fair value hedges to convert a fixed rate bond portfolio to floating, which would still require mark-to-market of each item in the portfolio for the hedged risk; also see subsequent section on duration hedging). This will eliminate earnings distortion from non-hedge accounting relationships that are effective hedges (thereby benefitting investors).

Note - Expansion of portfolio hedge accounting is gaining acceptance by state regulators in the U.S. (e.g., U.S. statutory proposal for fair value hedge accounting for portfolios of derivatives hedging variable annuity guarantee liabilities).

Asset/Liability Duration Hedging

A key component of insurance companies' risk mitigation is aligning the duration² of invested assets with product liabilities.

Insurance companies often have liabilities with durations in excess of 30-40 years that contain fixed interest rates; while investments available to support these liabilities with similar duration are often limited in supply (e.g., 30+ year bonds). This creates exposure to declining interest rates. For example, when insurance companies enter into long-term interest rate swaps (receive-fixed/pay-float) to reduce this duration mismatch, these swaps' durations are driven by the receive leg, which (at 30 or more years) helps extend the duration of the asset portfolio to approximate the duration of the product liabilities. This net duration gap is managed on a portfolio basis.

Current GAAP precludes hedge accounting for duration hedges due to strict portfolio hedging rules for fair value hedges and cash flow hedge accounting not being available for portfolio duration hedging. With the lack of hedge accounting, the mark-to-market ("MTM") on the derivative causes earnings distortion (financial statement geography mismatches), even though the derivative may be highly effective at reducing the asset/liability duration mismatch on an economic (i.e. cash flow) basis. For example:

- Available-For-Sale ("AFS") bonds: MTM recorded in OCI; interest income accruals recorded in earnings (levelized earnings)
- Product Liabilities: Varies but mainly based on amortized cost
- Derivatives (non-hedge accounting): MTM recorded in earnings

Proposed Solution

Since duration is a cash flow concept, we propose expanding the cash flow hedge accounting construct to duration hedges by recording the duration derivative MTM in OCI (to the extent effective) and swap income settlements accruals in income:

- Effectiveness testing (with a continued highly effective standard and quarterly quantitative testing) would be based on proving hedging derivatives lessen duration mismatch between designated liabilities and supporting investments
- This would coincide with AFS bonds and/or loans earnings patterns and is generally consistent with insurance liabilities earnings patterns (and economics of the transactions)

² Duration determined by the weighted average maturity of cash flows, as well as change in value of an instrument in response to change in interest rates.

- Earnings would therefore reflect the risk mitigation of the derivatives, instead of generating significant net income or loss in excess of the hedged item (i.e., avoids earnings distortion to investors)

Duration hedging mechanics could include the following:

- Designation - cash flow hedge of variability of cash receipts from bond investments less insurance liabilities due to duration mismatches
- Effectiveness Testing – hypothetical derivative method
 - For the amount of duration mismatch eliminated, compare/regress actual hedging derivative pool with perfect hypothetical
 - Most duration derivative programs hedge most (but not all) duration mismatch (under-hedges)
 - If hypo and actual achieve same amount duration mitigation, hypo and actual may be able to be assumed the same
- Derivative MTM recorded in OCI (to the extent effective); and swap settlement accruals recorded in earnings
 - Interest rate swaps consist of only interest rate settlements; therefore, all derivative economics will affect earnings in a manner (and timing) consistent with the hedged item (bonds)
 - Could fast-track guidance by limiting to vanilla interest rate swaps (avoids structuring loophole attempts by others)

Minimum Interest Guarantees

The value of minimum interest guarantees on participating and universal life-type contracts is not reported under U.S. GAAP unless it creates a premium deficiency. This creates an accounting mismatch with any hedging instruments (such as swaps and swaptions) used to hedge the risk associated with such guarantees:

- The change in fair value of the hedging instruments is reported in net income and the balance sheet
- No corresponding change in the value of the guarantee is reported in the financial statements

Current GAAP precludes hedge accounting (similar to duration hedges). Permitting changes in the fair value of hedged guarantees to be reported in net income as part of the insurance contracts standard update could remedy this issue.

Business Combination Foreign Currency Hedges

When an entity purchases a foreign entity in a business combination, the purchase price will often be denominated in a foreign currency. Derivatives are often used by the acquiring company to hedge the FX risk of the purchase price between purchase agreement date and closing date. This causes a GAAP income statement mismatch between the hedging derivative (recognized in earnings during the period between the purchase agreement date and closing date) and the hedged item (net assets of the

acquired company, earnings of which are recognized after closing date), because U.S. GAAP prohibits hedge accounting to transactions accounted for as a business combination. This accounting geography mismatch is misleading to investors. Since the foreign currency risk of a probable business combination represents an economic exposure that ultimately impacts earnings, we encourage the Board to add this purchase as an eligible hedged item (thereby properly reflecting the purchase price of the business combination).

III. Comments Summary

We believe that most of the proposals in the exposure draft will further the FASB objective of “improving the financial reporting of hedging relationships to better portray the economic results of an entity’s risk management activities”. However, these objective advancements may be modest for many entities. Furthermore, we believe the additional proposals noted above (in section II) will have a significant and positive impact on the FASB objective and strongly encourage their consideration for future inclusion. If included, these additional changes will be beneficial for investors by eliminating earnings distortions, as insurance company financial statements will appropriately reflect the economic results of their risk management activities.

IV. Questions for Respondents

Question 1: The Board decided it would allow an entity to designate the hedged risk as the variability in cash flows attributable to changes in a contractually specified component stated in the contract in a cash flow hedge of a forecasted purchase or sale of a nonfinancial asset. Do you agree with that decision? Please explain why or why not. If not, what specific alternatives should the Board consider? Please explain why those alternatives would be beneficial.

- ***Yes, this is a reasonable premise assuming effectiveness can be proven to be highly effective. Being that current existing effectiveness test thresholds are rigorous, a principle based approach of passing the highly effective test can serve as the backbone to hedge accounting qualification (thereby making less restrictions more tolerable). Note - This proposal would not have a significant impact to our industry, as most of our hedged cash flows are related to financial assets.***

Question 2: The Board decided that it would retain the concept of benchmark interest rates for hedges of fixed-rate financial instruments and forecasted issuances or purchases of fixed-rate financial instruments, maintain the existing list of permissible benchmark rates, and add the SIFMA Municipal Swap Rate to the list.

- a. Should the Board retain the current concept of benchmark interest rates for fair value hedges of fixed-rate financial instruments and for cash flow hedges of forecasted issuances or purchases of fixed-rate financial instruments? Please explain why or why not.
 - b. If the Board continues to maintain the current concept of benchmark interest rates, should the Board consider within the concept expectations that a rate will become widely used?
 - c. If the Board continues to maintain a list of rates, are there any other rates that should be added to the list? Please explain why a particular rate meets the definition of a benchmark rate.
 - d. Are there other alternatives to the current concept of benchmark interest rates the Board should consider (for example, a principles-based approach)? Please describe those alternatives.
- ***We support the addition of the SIFMA Municipal Swap Rate as an eligible benchmark interest rate, as well as the exposure draft’s contractually specified interest rates for hedge accounting qualification. We believe greater realization of the aforementioned FASB objective would likely occur if more market rates were eligible for hedge accounting. This assumes they are part of an arm’s length derivative trade with a third party, are reliably measurable (e.g., prime rate, which***

appears to meet the definition of benchmark interest rate in that it can be attributable to high-credit-quality obligors), and do not have significant credit risk embedded in them. Overall, a more principle based approach is favored which would emphasize current existing effectiveness test thresholds as the main decider of hedge accounting qualification (i.e., passing the highly effective test can serve as the backbone to hedge accounting eligibility).

Question 3: The Board decided that it would allow an entity to use either the full contractual coupon cash flows or the cash flows associated with the benchmark rate determined at hedge inception in calculating the change in the fair value of the hedged item attributable to interest rate risk, except when the current market yield of the financial instrument is below the benchmark rate at hedge inception. In that instance, the total contractual coupon cash flows would have to be used. Do you agree with this decision? Please explain why or why not.

- ***Being that current existing effectiveness test thresholds are rigorous, a principle based approach of passing the highly effective test can serve as the backbone to hedge accounting qualification. Therefore, benchmark rates and contract rates could qualify as hedged items as long as they meet the highly effective threshold.***

Question 4: In regard to hedging forecasted transactions, paragraph 815-30-40-5, as amended, states that “a pattern of determining that hedged forecasted transactions are probable of not occurring would call into question both an entity’s ability to accurately predict forecasted transactions and the propriety of using hedge accounting in the future for similar forecasted transactions.” What is your policy on what constitutes a pattern? Are there certain instances or scenarios in which missed forecasts should not be incorporated into the consideration of this pattern?

- ***The guidance states that having a pattern of determining that hedged forecasted transactions probably will not occur, will call into question an entity's ability to accurately predict forecasted transactions and the propriety of using hedge accounting in the future for similar forecasted transactions. The guidance does not differentiate between assets for which cash flows are currently being hedged (i.e., variable fixed instrument that is swapped to fixed rate) and transactions that will not occur until a future date (i.e., forecasted transactions). For the former, an entity may be required to sell the hedged asset for events outside the entity's control, such as credit events or restructurings. This type of transaction should not call into question an entity's ability to accurately predict forecasted transactions and should be viewed differently from a forecasted purchase that did not occur.***

Question 5: Are there hedging relationships that would be eligible to meet the requirements in the proposed amendments and IFRS 9, but the hedge results would be recognized and presented differently? If so, please describe the transaction and why it would be recognized and presented differently in accordance with IFRS 9.

- ***Since IFRS-9 does not prescribe income presentation of hedging results, we presume hedging results presentation would vary between U.S. GAAP and IFRS (as well as between IFRS filers). For example, IFRS 9 does not require the presentation of the excluded component of a hedging relationship in the same line item, etc.***

Question 6: Do you agree with the following Board decisions on presentation? Please explain why or why not. If not, what other alternatives should the Board consider?

- a. For qualifying fair value, cash flow, and net investment hedges, the proposed amendments would modify current GAAP by requiring the entire change in the fair value of the hedging

instrument included in the assessment of hedge effectiveness to be presented in the same income statement line item in which the earnings effect of the hedged item is presented.

- b. For qualifying fair value, cash flow, and net investment hedges, the proposed amendments would retain current GAAP by requiring changes in the fair value of the hedging instrument excluded from the assessment of effectiveness to be recorded currently in earnings. For qualifying fair value and cash flow hedges, the proposed amendments would modify current GAAP by requiring changes in the fair value of the hedging instrument excluded from the assessment of effectiveness to be presented in the same income statement line item in which the earnings effect of the hedged item is (or will be) presented. For qualifying net investment hedges, there will be no prescribed presentation requirements for changes in the fair value of the hedging instrument excluded from the assessment of effectiveness.
- c. For cash flow hedges in which the hedged forecasted transaction is probable of not occurring, the proposed amendments would retain current GAAP by requiring amounts recorded in accumulated other comprehensive income to be reclassified to earnings immediately. However, the proposed amendments would require presentation of reclassified amounts in the same income statement line item in which the earnings effect of the hedged item would have been presented had the hedged forecasted transaction occurred.
- ***While we agree with reporting the effect of the hedging instrument in the same income statement line as the hedged item, we do support some exceptions:***
 - ***Net interest margin (net investment income less product crediting rates) and other related measures are key indicators of insurance company operating performance. Because net investment income (NII) and interest expense drive many of these significant financial metrics, we believe it is appropriate to record the interest portion of derivatives and hedged items in the same income statement line (e.g., NII, interest expense), and other related hedge and hedged item components (including ineffectiveness) in another gain/loss item in the income statement (e.g., realized gain/loss).***
 - ***We are concerned that recognizing ineffectiveness with the hedged item could have some unintended consequences and be misleading to investors, depending on the size of an insurer's hedging program. For example, if a hedged forecasted debt issuance does not occur, the proposed guidance seems to indicate that the (now de-designated cash flow hedge accounting derivative) impact be reclassified from OCI to interest expense. Since the hedged item did not materialize in the financial statements, we believe the hedge would be more reasonably recorded with other derivatives where non-hedge accounting is applied.***
 - ***We are also concerned about the deferral of amounts in OCI from cash flow hedge ineffectiveness. One could support the premise that the ineffective part of a hedging derivative is hedging "nothing" (i.e., speculative), and therefore should be recognized in earnings immediately. This is not an issue for fair value hedges, since their entire fair value changes are recognized in earnings. Deferring large (ineffective) amounts in OCI can cause earnings surprises to investors when accumulated amounts are reclassified to earnings (as well as cause forecast challenges for companies).***

Question 7: Do you agree with the proposed disclosure amendments in (a), (b), and (c) below? Please explain why or why not.

- a. Cumulative basis adjustments related to fair value hedges
 - b. Quantitative hedge accounting goals, if any, that an entity sets when developing its hedge accounting objectives and strategies and whether it met those goals
 - c. Revised tabular disclosure for fair value and cash flow hedges that would focus on the effect of hedge accounting on income statement line items.
- ***Because current derivative footnote disclosures (along with derivative information included in the fair value footnote) are significant and voluminous, we believe the information associated with the additional proposed disclosures are already adequately covered by current disclosures quantitatively and/or qualitatively.***
 - ***Also, while hedging strategies are described qualitatively in detail in current disclosures, some companies do not set quantitative hedge accounting goals. Our industry seeks to hedge virtually all risks through the use of the most appropriate hedging methods (including derivatives) and apply hedge accounting when permissible under FASB guidance.***

Question 8: Unless the hedging relationship meets one of the exceptions that assumes perfect offset at hedge inception, an entity would be required to perform an initial quantitative test of hedge effectiveness and would be allowed to perform subsequent hedge effectiveness assessments qualitatively unless facts and circumstances change. Do you agree with this proposed change? Please explain why or why not.

- ***The ACLI supports the proposed qualitative testing option, which could potentially save significant operational resources. However, some companies may not utilize this option due to the qualitative compliance documentation (and accompanying audit inquiries); and quarterly quantitative testing (for non-critical terms and shortcut items) avoids accumulated year-end surprises for companies and investors.***

Question 9: The Board decided that an entity may elect at hedge inception to perform subsequent assessments of effectiveness qualitatively. However, certain changes in the facts and circumstances associated with the hedging relationship in subsequent periods may require a quantitative assessment of effectiveness to be performed. Once an entity determines that a quantitative assessment of effectiveness is required, the entity would be prohibited to return to qualitative testing in periods after this determination is made. Can situations arise in which an entity no longer may assert qualitatively that the hedging relationship continues to be highly effective but when tested quantitatively would be highly effective? If so, please describe those circumstances. Should an entity be allowed to return to qualitative testing after such a significant change in facts and circumstances precluded it in a prior period? If so, please discuss the factors that an entity should consider to justify a reasonable expectation that the hedge will once again be highly effective on a qualitative basis.

- ***We feel that in certain cases, companies should be able to return to performing a qualitative analysis. An example would be when actuarial assumptions for policyholder behavior become uncertain for a limited time, which would necessitate quantitative testing. This could happen when a cohort of deferred annuities reaches the end of the surrender charge period. As soon as more stable, predictable relationships return, companies should be able to perform qualitative analysis again.***

Question 10: Do you agree with the proposed amendment that would allow an entity to perform the initial quantitative testing portion of hedge documentation at any time between hedge inception and the quarterly effectiveness testing date using data applicable as of the date of hedge inception? Please

explain why or why not.

- ***We are supportive of the proposal for more flexibility (e.g., until quarter-end) to perform initial quantitative assessment of hedge effectiveness. However, some companies may not utilize this option, as contemporaneous testing can avoid possible quarter-end surprises that could come with delaying the tests.***

Question 11: The proposed amendments related to the timing of the preparation of hedge documentation and subsequent qualitative testing apply to both public entities and private companies. Are there valid reasons why the content of or the timing of the preparation of hedge documentation should be different for public entities and private companies? If so, please describe the specific types of transactions for which different treatment should be considered.

- ***We believe the requirements should be consistent for both public and private entities.***

Question 12: Should the effective date be the same for both public business entities and entities other than public business entities?

- ***We believe the effective dates should be consistent for both public and private entities.***

Question 13: How much time is needed to implement the proposed amendments? Should entities other than public business entities be provided more time? If so, how much more time?

- ***We believe the effective date should be no sooner than 2 years from release of the final guidance and that early adoption should be permitted. We also believe the effective dates should be consistent for both public and private entities.***

Question 14: Do you agree with the proposed transition method and disclosures in paragraph 815-20-65-3? Do you agree with the Board's decision not to allow a retrospective transition approach? Please explain why or why not.

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- ***As many existing hedge accounting relationships have 10+ years history, retrospective transition approaches will likely be complex, time consuming, and may not be understood by investors. A prospective approach allowing for redesignation of existing hedge relationships is more practical assuming disclosure of all these hedging relationships shows the impact on current year results.***

The American Council of Life Insurers welcomes the Board's and staff's feedback on our submission. Please do not hesitate to contact me at MikeMonahan@accli.com, or by phone, 202-624-2324. Thank you.

Sincerely,



Mike Monahan
Senior Director, Accounting Policy